

Independent Auditor's Report





United States Department of State

Washington, D.C. 20520

June 22, 2000

**INFORMATION MEMORANDUM
S/S**

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TO: The Acting Secretary

FROM: *John L. Williams-Bridgers* for
OIG - Jacquelyn L. Williams-Bridgers

SUBJECT: Audit of the Department of State's 1999 and 1998
Principal Financial Statements - Audit Report
00-FM-022

SUMMARY

The Government Management Reform Act (GMRA) requires that the Office of Inspector General audit the agency's overall financial statements and submit its report to the head of the agency. Our opinion on the Department's 1999 and 1998 Principal Financial Statements is unqualified, which means the financial statements were free of material misstatement. However, our report brings to management's attention three significant internal control weaknesses and several instances of noncompliance with laws and regulations.

DISCUSSION

Consistent with GMRA requirements, a copy of our audit opinion on the Department's 1999 and 1998 Principal Financial Statements is attached. At the direction of my office, Leonard G. Birnbaum and Company performed the audit.

The audit objective was to obtain reasonable assurance and express an opinion on whether the Principal Financial Statements were free of material misstatement. We are issuing an unqualified opinion on the 1999 and 1998 Principal Financial

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Statements. The report brings to management's attention concerns with security over the domestic main frame computers and the Paris Accounting and Disbursing System; the inadequacy of internal controls over the management of unliquidated obligations; and the inadequacy of the Department's financial and accounting system, which is both an internal control weakness and an issue of noncompliance with several laws and regulations, including the Budget and Accounting Act of 1950, the Federal Managers' Financial Integrity Act, the Chief Financial Officers Act, and the Federal Financial Management Improvement Act. We also bring to management's attention noncompliance with GMRA, which requires agencies to prepare audited financial statements and submit them to the Office of Management and Budget by March 1 of each year.

The Bureau of Financial Management and Policy (FMP) agreed with our findings and conclusions, and its comments are included as Appendix A to the report. In addition to this report, we will be sending a separate management letter, prepared by our contractor, to FMP discussing several other matters that were identified during the audit.

We are pleased with the improvements that the Department has made in financial management since the CFO Act was passed in 1990. However, a number of improvements still need to be made, as described in the report. We also believe that the Department should devote adequate resources to financial statement preparation to ensure that it can issue audited financial statements by March 1.

We appreciate the cooperation extended to us by the Department's managers and staff during the audit.

Attachments:

Tab 1 -- Audit Report 00-FM-022

cc: FMP - Mr. Bert T. Edwards

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INDEPENDENT AUDITOR'S REPORT

To the Secretary, Department of State:

We have audited the Department of State's (Department) Consolidated Balance Sheets, Consolidating Statements of Net Cost, Consolidated Statements of Changes in Net Position, Combined Statements of Budgetary Resources and Statements of Financing (Principal Financial Statements) and Required Supplementary Stewardship Information as of and for the years ended September 30, 1999 and 1998, and have examined internal control over financial reporting in place as of September 30, 1999.

In our opinion, the Department's 1999 and 1998 Principal Financial Statements are presented fairly in all material respects.

We found:

- no material conflicts with the Department's 1999 report on management controls, prepared under the Federal Managers' Financial Integrity Act of 1982, which cites the financial and accounting system, and information systems security as material weaknesses, and
- instances, as noted below, of noncompliance with selected provisions of applicable laws and regulations.

Each of these conclusions is discussed in more detailed below. This report also discusses the scope of our work.

PRINCIPAL FINANCIAL STATEMENTS

In our opinion, the Department's 1999 and 1998 Principal Financial Statements and Required Supplementary Stewardship Information, including the notes thereto, present fairly, in all material respects, the Department's financial position as of September 30, 1999 and 1998, and the net cost of operations, the changes in net position, the use of budgetary resources, and the use of financing resources for the years then ended, in conformity with generally accepted accounting principles.

This report incorporates the results of our separate audits of the financial statements of the Foreign Service Retirement and Disability Fund (FSRDF) which, as of September 30, 1999, comprised over 50 percent of the Department's assets and 81 percent of its liabilities, and the financial statements of the International Cooperative Administrative Support Services (ICASS) program. Audits of FSRDF's and ICASS' statements as of, and for the years ended, September 30, 1998 and 1999, resulted in unqualified opinions.

INTERNAL CONTROL

We considered the Department's internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the Principal Financial Statements and Required Supplementary Stewardship Information, and not to provide assurance on internal control. Consequently, we do not provide an opinion on internal controls.

The objectives of internal control are to provide management with reasonable, but not absolute, assurance that the following objectives are met:

- transactions are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over assets;
- funds, property, and other assets are safeguarded against loss from unauthorized acquisition, use, or disposition;
- transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements and other laws and regulations that the Office of Management and Budget (OMB), Department management, or the Inspector General have identified as being significant for which compliance can be objectively measured and evaluated; and

- data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Our consideration of internal control would not necessarily disclose all matters of internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgement, could adversely affect the Department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors or irregularities in amounts, which would be material in relation to the financial statements being audited or material to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

We noted the following matter that we considered to be a material weakness as defined above. The Department's mainframe computers for domestic operations are considered vulnerable to unauthorized access; consequently, other systems, including the Department's financial management systems, which process data using these computers, may also be vulnerable. Similar access control weaknesses were found in the Paris Financial Service Center's Accounting and Disbursing System.

We noted certain matters, discussed in the following two paragraphs, involving internal control that we consider to be reportable conditions.

The Department's financial and accounting system, as of September 30, 1999, was inadequate. The principal areas of inadequacy were:

- certain elements of the financial statements including, but not limited to, real property, personal property, capital improvements, and capital leases are developed from sources other than the Department's trial balance;
- some fund balances with Treasury, as reported on the Department ledgers, were not reconcilable with balances reported by Treasury; the Department's records reflect \$97 million less than the corresponding Treasury balances, a difference that is not considered material;
- audited financial statements are not issued on a timely basis; and

- unliquidated obligation balances were not reconcilable with detail maintained in related databases.

The Department's internal control process related to the management of unliquidated obligations was inadequate. This included unsupported obligations and lack of a structured process to reconcile and deobligate funds in a timely manner. For example, review of \$279 million of unliquidated obligations that had no activity during FY 1999 disclosed that 47 percent, or \$132 million, should have been deobligated. A majority of the \$132 million was related to obligations over 1 year old.

We noted certain other internal control issues that we have reported to the Department's management in a separate letter dated April 28, 2000.

COMPLIANCE WITH LAWS AND REGULATIONS

The Department's management is responsible for complying with laws and regulations applicable to the Department. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the Department's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in Office of Management and Budget Bulletin 98-08, *Audit Requirements for Federal Financial Statements*, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. However, the objective of our audit of the Principal Financial Statements, including our tests of compliance with selected provisions of applicable laws and regulations, was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions in statutes and regulations, that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements or that sensitivity warrants disclosure thereof.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph disclosed the following instances of noncompliance with laws and regulations, which are required to be reported under *Government Auditing Standards* and OMB Bulletin 98-08.

- The inadequacies of the Department's financial management systems are a failure to comply with:
 - the Budget and Accounting Procedures Act of 1950, which requires an accounting system that provides full disclosure of the results of financial operations, adequate financial information needed in the management of

operations and the formulation and execution of the budget, and effective control over income, expenditures, funds, property, and other assets;

- the Federal Managers' Financial Integrity Act (FMFIA) of 1982, which requires implementation of internal accounting and administrative controls that provide reasonable assurance that (1) obligations and costs are in compliance with applicable laws, (2) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation, and (3) revenues and expenditures applicable to Department operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets;
- the Chief Financial Officers Act of 1990, which requires the development and maintenance of an integrated accounting and financial management system that (1) complies with applicable accounting principles, standards and requirements, and internal control standards, (2) complies with such policies and requirements as may be prescribed by the Director of OMB, (3) complies with any other requirements applicable to such systems, and (4) provides for (i) complete, reliable, consistent, and timely information that is prepared on a uniform basis and that is responsive to the financial information needs of agency management, (ii) the development and reporting of cost information, (iii) the integration of accounting and budgeting information, and (iv) the systematic measurement of performance;
- OMB Circular A-127, Financial Management Systems, which requires the Department to establish and maintain an accounting system that provides for (1) complete disclosure of the financial results of the activities of the Department, (2) adequate financial information for Department management and for formulation and execution of the budget, and (3) effective control over revenue, expenditure, funds, property, and other assets; and
- The Government Management and Reform Act of 1994, which requires the heads of designated executive agencies to prepare and submit to the Director of OMB an audit of financial statements by March 1, covering the preceding fiscal year.

The results of our tests of compliance with other laws and regulations disclosed no material instances of noncompliance. Compliance with the FFMIA is discussed below.

Under FFMIA, we are required to report whether the Department's financial management systems substantially comply with the Federal financial management system requirements,

applicable accounting standards, and the United States Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA issued by OMB on September 9, 1997.

The results of our tests disclosed instances, described below, where the Department's financial management systems did not substantially comply with the requirement to follow the Federal financial management system requirements. OMB implementation guidance states that, to be in substantial compliance with this requirement, the Department must (1) meet Circular A-127 requirements, including the requirement to support management's fiduciary responsibility, (2) follow requirements published in Joint Financial Management Improvement Program's (JFMIP) *Federal Financial Management System Requirements* series, and (3) comply with Circular A-130, Appendix III, *Security of Federal Automated Resources*. We found instances of substantial noncompliance with these three standards.

- Circular A-127 requires that the Department's systems support management's fiduciary role by providing complete, reliable, consistent, timely, and useful financial management information. Based on the weaknesses related to financial management systems discussed in the report on internal controls and the preceding paragraphs in the report on compliance, we determined that the Department was not substantially in compliance with this standard.
- JFMIP's *Federal Financial Management System Requirements* state that the core financial management systems must support the partnership between program and financial managers, and assure the integrity of decisionmaking information including the ability to collect accurate, timely, complete, reliable, and consistent information. JFMIP also requires that the core financial system be able to provide financial information to support internal and external reporting requirements, including as necessary the requirements for financial statements. OMB guidance states that one indicator of compliance with this standard is that the Department's core financial system, supported by other systems containing the detailed data summarized in the core financial system, be the source of information for the preparation of the annual financial statements. However, the Department's core financial system is not the sole source of information used in the preparation of the annual financial statements. Based on these issues, we determined that the Department did not substantially comply with this standard.
- Circular A-130, Appendix III, requires that the Department assure an adequate level of security for all agency automated information systems, specifically, the Department shall assure that automated information systems operate effectively and assure that there are appropriate safeguards in the automated information systems. Based on our concerns related to the financial management systems discussed in the report on internal control and the preceding paragraphs in the report on compliance,

we determined that the Department was not substantially in compliance with this standard. The Circular A-130 also requires that the Department assure the continuity of operations of automated information systems that support critical agency functions. However, we found that the Department had not established a complete contingency/business recovery plan for Central Financial Management System.

The Department's Bureau of Financial Management and Policy has overall responsibility for the Department's financial management systems. The foregoing noncompliance is caused by the lack of organization and integration of the Department's financial management systems.

This issue has been highlighted in the Department's annual FMFIA report since 1983. In our audits of the Department's 1997 and 1998 Principal Financial Statements, we observed that the Department's financial management systems were not in compliance with FFMIA and recommended that a remediation plan be prepared. The Department submitted its remediation plan regarding noncompliance with FFMIA to OMB on March 16, 2000, which projects achieving substantial compliance during FY 2003.

We noted certain other instances of noncompliance that we have reported to the Department's management in a separate letter dated April 28, 2000.

RESPONSIBILITIES AND METHODOLOGY

Department management has the responsibility for:

- preparing the Principal Financial Statements in conformity with generally accepted accounting principles;
- establishing and maintaining effective internal control; and
- complying with applicable laws and regulations.

Our responsibility is to express an opinion on the Principal Financial Statements and Required Supplementary Stewardship Information based on our audit. Generally accepted auditing standards require that we plan and perform the audit to obtain reasonable assurance about whether the Principal Financial Statements are free of material misrepresentation and presented fairly in accordance with generally accepted accounting principles. We considered the Department's internal control for the purpose of expressing our opinion on the Principal Financial Statements and Required Supplementary Stewardship Information referred to above and not to provide an opinion on internal control. We are also responsible for testing compliance with selected provisions of applicable laws and regulations that may materially affect the financial statements.

In order to fulfill these responsibilities, we

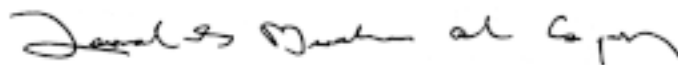
- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the Principal Financial Statements and Required Supplementary Stewardship Information;
- obtained an understanding of the internal controls over financial reporting;
- tested compliance with selected provisions of laws and regulations that may materially affect the financial statements; and
- performed other procedures as we considered necessary in the circumstances.

Our audits were conducted in accordance with generally accepted auditing standards, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and OMB Bulletin 98-08. We believe that our audits provide a reasonable basis for our opinion.

The *Overview* and *Required Supplementary Information* sections contains a wide range of data. Professional standards require the auditor to read this information and consider whether this information, or the manner of its presentation, is materially inconsistent with the information, or the manner of its presentation, in the Principal Financial Statements. If the auditor concludes that there is a material inconsistency, the auditor should determine whether the Principal Financial Statements or the other information require revision. We found no inconsistencies between data contained in the Overview and Required Supplementary Information and corresponding data contained in the Principal Financial Statements.

This report is intended for the information of the Inspector General of the U.S. Department of State and the Department's management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Comments by the Department's management on this report are presented as Appendix A.



Leonard G. Birnbaum and Company

Alexandria, Virginia
April 28, 2000



APPENDIX A
United States Department of State

Deputy Chief Financial Officer

Washington, D.C. 20522-1506

MEMORANDUM

JUN 15 2000

TO: OIG/AUD - Mr. J. Richard Berman
FROM: FMP/F - Larry J. Eisenhart
SUBJECT: Draft Audit Report on the Department of State's 1999 Consolidated Financial Statements

This is in response to your request for comments on the draft report titled "Audit of the Department of State Consolidated 1999 Financial Statements." In relation to internal control, the report cites the Department's computer access controls as a material weakness and two reportable conditions: (1) the inadequacy of the Department's financial management systems and (2) the inadequacy of the management of the unliquidated obligation process. In addition, the Department's financial management systems have been reported as noncompliant with laws and regulations, including the Federal Financial Management Improvement Act of 1996 (FFMIA).

Since the GAO review of the Department's computer security, the Department has implemented a number of mainframe and other information system security measures. These measures are discussed in the Department's 1999 Review of Management Controls prepared in accordance with the Federal Managers' Financial Integrity Act of 1982. It is expected that the remaining material weakness on information systems security will be closed in 2000. To ensure that adequate controls are in place in the Central Financial Management System (CFMS), FMP contracted with a CPA firm to develop policies, procedures, CFMS security awareness training and a recurring evaluation process. The initial efforts in this area have been completed.

The weaknesses in the Department's financial management systems are a long-standing problem. Substantial compliance with FFMIA is a top priority of the Department, and improvement initiatives to achieve that goal are underway. As required by FFMIA, the Department submitted its remediation on March 16, 2000. Strengthening the management of unliquidated obligations is also an important financial management initiative. We continue to develop reports and procedures to use in reviewing obligations.

We thank you for the opportunity to comment on the draft report and for working with us in a collaborative manner on the FY 1999 financial statements. We believe that our offices have made considerable progress over the past several years. The Department is committed to continuing its efforts to improve management of its programs and the quality of its financial reporting. If you have any questions concerning our response to the audit report, please contact Christopher H. Flaggs, Managing Director, Financial Policy, Reporting and Analysis, on (202) 261-8625.